7-1-1961

Tax Planning the Foreign Investment: A Survey of the Jurisdictional Pattern

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TAX PLANNING THE FOREIGN INVESTMENT: A SURVEY OF THE JURISDICTIONAL PATTERN

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I. INTRODUCTION

It is almost axiomatic that tax planning the foreign investment and business activities of United States taxpayers under the Internal Revenue Code is a task of tailoring the plan to the needs of the particular taxpayer; ready-made formulae are non-existent. Thus, the tax planner in this area may be required to consider, *inter alia*, the effect of United States tax jurisdiction over the various taxable entities, the geographic source of income rules, the vagaries of the foreign tax credit, the variety of legislative and judicial restraints on tax avoidance, the modifications of the basic rules by one or more tax conventions, and the rules governing the effect of foreign currency devaluation and blockage. However, perhaps the two most fundamental United States tax factors guiding foreign tax planning are: first, the manner in which Congress has asserted jurisdiction over taxable entities; and, second, the rules governing the determination of the source of income. This article is concerned with the former and its function is to outline the United States tax advantages of the various legal entities engaged in international trade and investment.

In broad outline, in the corporate entity jurisdictional pattern, the Code draws a line between domestic and foreign corporations, the latter being characterized as resident or nonresident. However, with respect to domestic corporations, there has been a pronounced trend toward a proliferation of types accorded special treatment. Also, the United States citizen, otherwise taxable on his world-wide income, has been accorded special treatment in three instances. Perhaps only the foreign trust may be regarded as being in a unique position without explicit statutory recognition having to draw on the statutory clothing of the nonresident alien individual.

On the basis of the foregoing, the entity jurisdictional aspects of foreign commercial activity may be classified as follows: (1) branch and subsidiary operations of domestic corporations; (2) foreign subsidiary operations; (3) Western Hemisphere Trade Corporations; (4) Possessions Corporations; (5) China Trade Act Corporations; (6) Foreign Business Corporations (proposed); (7) foreign investment companies; (8) foreign situs trusts; and (9) foreign income of United States citizens.

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II. BRANCH AND DOMESTIC SUBSIDIARY OPERATIONS

A. IN GENERAL

The United States asserts tax jurisdiction over ordinary[1] domestic corporations on their world-wide income as earned. A domestic corporation is defined as one "created or organized in the United States or under the law of the United States or of any State or Territory."[2] All other corporations are foreign corporations subject to tax only on their United States source income. Thus, Congress has seen fit to draw the jurisdictional line on the purely formal basis of the geographic locus of the sovereign issuing the corporate charter. As will be more fully discussed below in connection with foreign subsidiary operations, the foregoing jurisdictional line has the effect of providing the United States corporate investor with an important choice of form in conducting foreign business operations. But it follows from the above, that where business or other non-tax reasons dictate the use of some form of a domestic entity in conducting foreign business, United States tax advantages are ordinarily regarded as being minimal; the immediate generation of both foreign and United States tax is most often thought of as a substantial disadvantage compared to operating in foreign corporate form notwithstanding the availability of credit for foreign income taxes paid.[3] Nevertheless, thoughtful tax planning can not neglect the tax advantages that do exist where foreign operations are to be conducted in some form of a domestic entity; in some situations a branch or domestic subsidiary will prove the most desirable legal form for tax as well as non-tax purposes.

B. TAX ADVANTAGES

Since tax advantages and disadvantages of particular legal forms are but relative to other forms, a survey of the advantages of each form will eliminate needless repetition. Considered here are the following advantages of conducting foreign operations and making of foreign investments in some form of a domestic entity: (1) more effective utilization of operating losses; (2) the availability of depletion allowances and development costs in foreign natural resource extraction; (3) freedom from a number of tax avoidance provisions governing transactions between separate entities; and (4) credit for dividends received.

1. *Operating Losses.* The use of a domestic form in conducting foreign business permits a United States corporation, both directly and indirectly, to maximize foreign incurred operating losses. Foreign business operations

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1. The term "ordinary" is used herein simply to distinguish such entity from the four special types of domestic corporations discussed *infra*, viz: Western Hemisphere Trade Corporation, Possessions Corporation, China Trade Act Corporation, and the proposed Foreign Business Corporation.
2. INT. REV. CODE OF 1954, § 7701(a)(4); unless otherwise indicated, all references are to INTERNAL REVENUE CODE OF 1954.
3. Sections 901-905.

can be carried out through a domestic department or branch or through a foreign branch, and operating losses therefrom can be offset against current income from domestic sources and other foreign branches.[4]

When foreign business is conducted through a domestic subsidiary, operating losses of the subsidiary may be spread over the nine-year period allowed by the Code,[5] and when the subsidiary is 80 percent owned by a domestic parent, the subsidiary's operating losses may be utilized by a parent after a tax-free liquidation of the subsidiary under section 332.[6] In the alternative, a domestic corporation is eligible to participate in a consolidated return where it is a member of an affiliated group and the other statutory requirements are met.[7]

2. *Natural Resource Extraction.* Operating abroad in domestic form preserves the statutory depletion allowances and development costs available to taxpayers engaged in natural resource extraction. When foreign law or other considerations require foreign incorporation, depletion and development costs ordinarily can be retained through an operating agreement with a foreign corporation formed for the purpose of holding the concession; production may be provided through capital and facilities provided by the United States taxpayer who is then regarded as having the requisite economic interest.[8]

3. *Tax Avoidance Transactions.* Operating or making foreign investment through a domestic or foreign branch, and in some instances through a domestic subsidiary, may provide a United States taxpayer with a substantial measure of freedom from a number of provisions of the Code designed to prevent tax avoidance. For example, while section 269, which permits disallowance of deductions, credits or allowances when corporate control is acquired for tax avoidance purposes, would have application with respect to a domestic subsidiary, the section would not rear its head with respect to branch operations.

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4. Under the recently established elective overall limitation on the foreign tax credit, branch gain in one country could be wiped out or reduced by loss in the other, resulting in elimination or reduction of credit for taxes paid the country where gain was realized; the overall limitation of § 904 is couched in terms similar to the same limitation contained in § 131(b)(2) of the 1939 Code, but it is now an alternative elective provision to the per country limitation. Section 904, as amended by PL 86-780, § 1 (1960), effective for taxable years beginning after 1960.

5. Section 172.

6. Section 381.

7. All corporations of an affiliated group may participate in a consolidated return (at a cost of 2% of consolidated taxable income) except exempt corporations, insurance companies, Possessions Corporations, China Trade Act Corporations, Regulated Investment Companies, § 1361 companies, and foreign corporations; however, 100% owned Mexican and Canadian subsidiaries under certain conditions are excepted from the latter group and may participate on the same basis as domestic corporations. Section 1504.

8. See Brudno, *Review of Considerations Arising in Foreign Oil Operations*, 9th OIL & GAS INST. 397, 438-40 (1958), an excellent treatment of the tax problems of foreign oil ventures.

Similarly, the same result would obtain with respect to section 341, which subjects gain on the disposition of stock of a collapsible corporation to tax as ordinary income, and to section 1551 which disallows the corporate surtax exemption and the $100,000 accumulated earnings tax, primarily upon transfers creating subsidiaries. Further, by definition, a domestic entity is not subject to the Foreign Personal Holding Company limitations.[9]

Section 482 of the Code permits the Service to reallocate income items, deductions, credits or allowances where two or more organizations are controlled by the same interests. While the breadth of this provision is sufficient to subject both branch and subsidiary operations to its strictures,[10] the section creates the most serious problems in connection with pricing practices between United States parents and their foreign subsidiaries.[11] The section ordinarily presents little difficulty with respect to domestic subsidiaries where income of both parent and subsidiary is subject in full to United States tax; in these cases, allocation of income through pricing arrangements ordinarily would not result in tax avoidance.[12]

Section 367 of the Code requires a taxpayer to secure an advance ruling from the Service in order to qualify a foreign corporate formation, reorganization, or liquidation of a foreign controlled subsidiary for nonrecognition of gain. A ruling clearing such a transaction will be given by the Service only if the taxpayer establishes that such proposed exchange is not motivated by tax avoidance. Failure to secure such favorable advance ruling subjects the taxpayer to the penalties of recognition of gain, on any appreciated property involved, in what otherwise would be a tax-free transaction.[13] Structuring foreign operations in branch or domestic subsidiary form avoids the restraints imposed by section 367. Domestic subsidiaries may be liquidated, corporate assets can be separated for export and import operations, capital in all forms can be transferred to overseas branches, and patents and trademarks can be moved freely from home plant to overseas branches and between branches without being subject to the limitations of section 367.

4. *Dividends Received.* Finally, operating in domestic entity form

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9. Section 552.

10. With respect to foreign branch operations, *e.g.*, a reallocation of income of such branch, which had been subject to foreign tax, to its United States parent could have the effect of reducing the available foreign tax credit.

11. See Baker, *Selection of Foreign or Domestic Corporations For Foreign Business Operations*, 8th ANNUAL TUL. TAX INST. 416 (1959).

12. See Brudno, *Tax Considerations in Selecting a Form of Foreign Business Organization*, 13 VAND. L. REV. 151, 156 (1959).

13. Section 367 applies to the non-recognition benefits granted by §§ 332, 351, 354, 355, 356 and 361.

A similar ruling is required under § 1491 which imposes a special 27.5% excise tax on unrealized gain where stock or securities are transferred to a foreign corporation (or foreign trust or partnership) as paid in surplus or as a contribution to capital. See Chommie, *Handling Tax Avoidance Exchanges and Transfers Involving Foreign Corporations Under Section 367*, P-H TAX IDEAS ¶ 8059 (1960); Whitehill, *Foreign Corporation Exchanges*, 36 TAXES 622 (1958). For a comparative analysis with similar United Kingdom legislation see Chommie, *United States and United Kingdom Tax Restraints in Forming, Reorganizing, and Liquidating Foreign Corporations*, 2 BOSTON COLLEGE INDUS. AND COML. L. REV. 1 (1960).

affords some decided advantages with respect to credit for dividends received. Dividends remitted to United States parents by domestic subsidiaries make available the 85 percent intercorporate dividend received credit;[14] this credit is available against dividends from foreign corporations only when the latter derive 50 percent or more of their gross income from United States sources and then only on a pro rata basis.[15] Individuals may qualify for the 4 percent dividend credit and $50 exclusion only against dividends from domestic corporations.[16]

III. Foreign Subsidiary Operations

A. in general

As noted above, Congress asserts tax jurisdiction over foreign corporations only on their United States source income; however, a distinction is drawn between resident and nonresident foreign corporations.[17] A resident foreign corporation—a corporation engaged in trade or business in the United States—is subject to corporate tax on all its United States source income; a nonresident foreign corporation—not engaged in business in the United States—is subject to United States tax only on its investment income at a flat 30 percent rate. It follows that where a foreign subsidiary corporation is not engaged in business in the United States and does not have United States investments, its foreign commercial activities do not generate income subject to United States taxes until it remits income (ordinarily in the form of dividends) to its United States shareholders.

B. tax advantages

The foregoing limitations on asserted jurisdiction over foreign corporations[18]—corporations formed under the laws of a foreign state—and other provisions permit a cataloguing of the tax advantages of foreign subsidiary operations on the following bases: (1) tax deferral of foreign source income; (2) base country operations; (3) freedom from certain limitations on tax avoidance; and (4) computations of the foreign tax credit.

1. *Tax Deferral.* Drawing the jurisdictional line simply on the basis of the locus of the political unit authorizing the birth of the corporate

14. Section 243, an advantage which perhaps can be regarded as a 7½% rate advantage (15 points x 52% rate) of branch over domestic subsidiary operations.

15. Section 245.

16. Sections 34(a) and 116(a).

17. Sections 881-882. Section 883 excludes transportation earnings of foreign corporations operating foreign registered ships and aircraft.

18. A broader jurisdiction is asserted over certain foreign investment companies, Foreign Personal Holding Companies, corporations whose investment income ("foreign personal holding company income") amounts to 60% of gross income and 50% of whose stock is owned directly or indirectly by not more than five United States citizens or residents. In such cases, corporate earnings are deemed distributed to the United States shareholders. Sections 551-558. The basis for jurisdiction under the foregoing provisions is, of course, that of United States citizenship or residence. This technique has been upheld against an attack of unconstitutionality. Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943).

entity affords United States investors the advantage of being able to maintain business management in the United States, and at the same time to withhold the foreign source income of a foreign subsidiary from the burdens of United States taxation, or to subject such income to United States tax as corporate remission policy may dictate. Further, the purely formal character of the jurisdictional test affords the maximum latitude in selecting the business method of engaging in international trade and investment. A United States controlled and managed foreign subsidiary may be used for import and export operations, for licensing, or for direct overseas investment without subjecting its foreign source income to United States tax.

However, the advantages of deferral are not unlimited. For example, if the effective income tax rate in a foreign country exceeds the 52 percent marginal rate imposed by the United States, there are no tax advantages from deferral alone. In such cases, remissions made regularly would be subject to United States tax, but tax liability would be wiped out completely by the credit for foreign income taxes paid by the subsidiary.

Notwithstanding the foregoing, the ability to defer United States tax on foreign source income of controlled foreign corporations is regarded as probably the major tax advantage of the foreign corporate form; and this tax advantage has undoubtedly contributed significantly in the management decision making the foreign corporation the dominant legal form in overseas investment in other than natural resource extractions.

2. *Base Company Operations.* When a United States investor has or can anticipate overseas investment in more than one foreign country, a foreign corporate subsidiary may be formed in a so-called tax haven or profit sanctuary country, selected perhaps because it does not impose an income tax or its tax jurisdiction is limited to the domestic income of its corporate entities. This subsidiary can perform a number of important business functions, including that of providing management guidance for the multiple-country operations.[19] In addition, a base company may provide the United States parent with a number of United States tax advantages. For one thing, the usual deferral of United States tax until remission can be carried beyond the profits of the base company from its own operations to include dividends from shares the base company may hold in other companies. All such profits may be transferred freely to other business units in the complex, permitting the base company to act as an intracompany banker, without exposing such foreign source income to United States tax.

The use of a base company also permits the averaging of foreign tax rates for purposes of the "per country" limitation on the credit for foreign tax paid. The Service regards foreign income taxes paid by a base company's

19. For a full discussion of base company operations including an outline of the business and tax law of selected tax haven countries, see GIBBONS, TAX FACTORS IN BASING INTERNATIONAL BUSINESS ABROAD (1957).

subsidiaries as being paid by the base company to the country of its incorporation.[20] However, the same averaging is available directly to United States corporations with respect to multiple foreign branch operations for tax years commencing after 1960.[21]

3. *Tax Avoidance Transactions.* While a number of statutory restrictions on tax avoidance pertain in particular to foreign corporations,[22] the use of a foreign subsidiary to conduct foreign business brings a substantial measure of freedom from other limitations. For example, the penalty tax on accumulated earnings applies only to the United States source income of foreign corporations,[23] and Service policy limits the application of the penalty tax when foreign corporations have individual shareholders subject to the progressive income tax.[24] Thus, as a general proposition, the foreign source income of a foreign operating or base company may be accumulated free of the risks of the accumulated earnings tax.

Considerations similar to the above obtain with respect to the limitations imposed by section 341 dealing with collapsible corporations. Section 341 denies preferential capital gain treatment (and certain other benefits) upon the disposition of stock of a collapsible corporation. While not completely free of doubt,[25] it would appear that failure to realize corporate foreign source income — the essence of collapsibility — would not bring into play the strictures of section 341 since United States jurisdiction over foreign corporations is limited to their United States source income.[26]

Finally, the Personal Holding Company provisions, which impose a penalty tax on certain domestic and foreign corporations, constitute no threat to a foreign corporation without United States source income.[27]

4. *Computation of the Foreign Tax Credit.* Section 902 of the Code grants a domestic corporation owning 10 percent or more of the stock of a foreign corporation credit against dividends received for foreign income

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20. I.T. 4089, 1952-2 CUM. BULL. 142. Averaging, however, in Brudno's words "is not an unmixed blessing"; base company foreign branch losses and high foreign rates, but within the "per country" limitation, can reduce the "average" considered paid by the base company resulting in a lower available credit to the United States parent on dividend remissions. Note 12 *supra*, at 163.

21. See note 4 *supra*.

22. *E.g.*, §§ 367 and 1491, discussed note 13 *supra*; §§ 551-558 (Foreign Personal Holding Companies), notes 9 and 18 *supra*; 482, requiring arms-length dealing between related organizations.

23. Gross income, a component of taxable income used in determining the base of the § 531 tax, of a foreign corporation is gross income only from United States sources. Section 882(b).

24. Treas. Reg. § 1.531-1(c) (1959).

25. Compare Brudno, *United States Taxation of Income From Abroad*, 1959 INST. PRIVATE INVESTMENT ABROAD 1, 24-25, with Gibbons, *op. cit. supra* note 19, at 29-31.

26. Sections 881(a), 882(b).

27. See analysis note 23 *supra*, the Personal Holding Company penalty tax also being imposed on a base requiring resort to the taxable income of a foreign corporation.

taxes paid by the subsidiary.[28] The technical niceties of the statutory formula of the foregoing "deemed paid" or "indirect" credit, leave the United States parent with a decided tax advantage over the use of a foreign branch in producing foreign income. Under the statutory terms as interpreted by the United States Supreme Court in *American Chicle Co. v. United States*,[29] only the amount of foreign income after foreign tax is taken into account in determining income for United States tax purposes, rather than the full amount of foreign profits as is the case of branch operations.[30] As a result, where the foreign tax rate is 26 percent, the effective United States rate on the parent will amount to 45.2 percent rather than 52 percent on comparable foreign branch income, a 6.8 point or 13 percent rate advantage.[31]

IV. WESTERN HEMISPHERE TRADE CORPORATIONS

A. IN GENERAL

In order to qualify for the special preferential tax treatment accorded Western Hemisphere Trade Corporations, a domestic corporation must:[32] (1) do all of its business, other than incidental purchases, in the Western Hemisphere; (2) derive 95 percent or more of its gross income from sources outside the United States; and (3) derive 90 percent or more of its gross income from the active conduct of a trade or business. Although, as a domestic corporation, a Western Hemisphere Trade Corporation is subject

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28. Indirect credit is also available against dividends routed home from a 50% owned subsidiary of a foreign subsidiary (§ 902(b)), and certain royalties paid in lieu of dividends by a 100% owned foreign subsidiary are treated as dividends. Section 902(b).

Foreign tax credit is not available against capital gains on liquidation of a foreign corporation. Freeport Sulphur Co. v. United States, 163 F. Supp. 648 (Ct. Cl. 1959). As a general rule, liquidation provides a tax advantage to a United States parent corporation only where foreign income tax rates are below 27%. However, the individual United States citizen or resident will always benefit from liquidating dividends rather than ordinary dividends because the indirect or deemed paid credit is available only to corporations. Of course, a foreign income tax imposed on any remittance itself would ordinarily constitute a levy subject to direct credit.

29. 316 U.S. 450 (1942).

30. This advantage may be short-lived; three bills (H.R. 5, H.R. 10859, H.R. 10860) introduced in the 86th Congress, all of which failed to pass, would have required "grossing-up" of the foreign income represented by the amount of foreign tax paid, eliminating the present advantage enjoyed on dividend remissions from foreign subsidiaries. Also, the Senate rejected a floor amendment to H.R. 10087 (PL 86-780, note 4 *supra*), providing for "grossing-up." However, from the foregoing failures it does not follow that "grossing-up" is dead; while opposition may be expected on broad grounds that "grossing-up" would deter rather than encourage foreign investment, it can be anticipated that the 87th Congress will be afforded the opportunity to consider the problem. For a critique see Corneel, *Grossing Up*, 38 TAXES 507 (1960).

31. Where the foreign rate is zero or 52% no advantage exists, the mathematics of the formula resulting in the maximum rate advantage at the midway point of 26%.

Barlow and Wender have expressed the effect of the statutory formula this way: "[T]he parent, instead of paying taxes at the United States rate of 52 per cent on all the earnings of its foreign subsidiary, pays the United States rate on that portion of income distributed in dividends, and the foreign rate on the balance." BARLOW & WENDER, FOREIGN INVESTMENT AND TAXATION 237 (1955).

32. Section 921.

to United States corporate tax on all its income as earned, it is allowed a "14 point" deduction from taxable income under a statutory formula.[33]

The policy justification for the preferential treatment accorded Western Hemisphere Trade Corporations is not articulated too clearly in the history of the legislation. However, it appears that Congress believed that the concession, originally a surtax exemption, was necessary in order to permit a small number of domestic corporations engaged in business in certain Latin countries to compete successfully with companies organized in other capital exporting countries.[34] In any event, the present "14 point" deduction provides a substantial tax concession, under certain circumstances, to a limited group of taxpayers and must be considered in planning business operations in the Western Hemisphere.

B. TAX ADVANTAGES

The tax advantages emitting from the use of a domestic corporation qualifying as a Western Hemisphere Trade Corporation center around the "14 point" deduction, which amounts to a 27 percent rate reduction. Thus, broadly, the special deduction results in an average effective United States corporate rate on income of these corporations ranging from 22 percent to 38 percent, compared to a 52 percent rate on the income of an ordinary domestic corporation. However, rate comparisons are more meaningful when Western Hemisphere Trade Corporation operations are compared with the major alternative methods of doing business in the Western Hemisphere through ordinary domestic corporations and foreign subsidiaries.

1. *Western Hemisphere Trade Corporation vs. Ordinary Domestic Corporation.*[35] Since both Western Hemisphere Trade Corporations and ordinary domestic corporations are subject to United States tax as earned, the "14 point" deduction constitutes an immediate and pronounced tax advantage. Therefore, when a domestic entity must be used, income derived from export operations (perhaps the dominant use made of the Western Hemisphere Trade Corporation), from licensing, and from direct investment in plant or other trade or business activity has a "14 point" deduction available as the income is earned. For example, in the case of foreign petroleum extraction operations, the effective United States rate on an ordinary domestic corporation may be as low as 26 percent (50 percent maximum depletion allowance), but the same corporation qualifying as a Western Hemisphere

33. Section 922.

34. For a critical analysis of the legislative history of the Western Hemisphere Trade Corporation concession, see Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 831-38 (1956).

35. In broad outline, the tax advantages of the ordinary domestic corporation discussed *supra* at pp. 362-65, apply to Western Hemisphere Trade Corporations; however, in computing the 2% tax on consolidated taxable income where a consolidated return is filed, Western Hemisphere Trade Corporations income is not taken into account. Section 1503(b).

Trade Corporation would pay only 19 percent (one half the 38 percent rate).[36]

2. *Western Hemisphere Trade Corporation vs. Foreign Subsidiary.* When the rate burden of a Western Hemisphere Trade Corporation is compared with the rate burden on a foreign subsidiary, a different picture unfolds. Assume, for example, a corporate policy of remitting half the earnings and reinvesting half, and an average effective foreign tax rate of 26 percent, a fairly typical Latin country corporate income tax burden. In this case, on the basis of $100 of foreign earnings, $26 would be payable to the foreign country and $9.62 ($37 dividend x 52 percent less $9.62 foreign tax credit) would be payable to the United States collector, a total effective rate of 35.6 percent; the burden on $100 of income of a Western Hemisphere Trade Corporation would be 38 percent on the basis of the marginal United States rate of 52 percent.

In the foregoing example the retained earnings of the foreign subsidiary would be subject to additional United States tax when remitted; where there is a total remission of foreign earnings by the subsidiary the Western Hemisphere Trade Corporation possesses a rate advantage, though a narrow one. Assume that both a Western Hemisphere Trade Corporation and a foreign corporation are subsidiaries of a United States parent and both remit all earnings. In this case, the combined United States and foreign effective rate on the foreign earnings, as discussed above,[37] amounts to 45.2 percent; the effective rate on the foreign earnings of the Western Hemisphere Trade Corporation is 42.8 percent,[38] a very narrow Western Hemisphere Trade Corporation advantage of 2.4 points and one perhaps not likely to control a management decision.

V. POSSESSIONS CORPORATIONS

A. IN GENERAL

United States possessions constitute a second geographic area where preferential tax treatment under the Code may be enjoyed.[39] The basic requirements for the possessions tax preference are not unlike those prescribed for Western Hemisphere Trade Corporation status. Thus, to qualify as a Possessions (section 931) Corporation, a domestic corporation must derive: (1) 80 percent or more of its gross income from within United States

36. Such reduced rate may be meaningless where foreign income taxes on petroleum extraction amount to 50% or more; in such case the foreign tax credit would normally eliminate United States tax liability. Further, the special tax position of the petroleum industry perhaps can not be dealt with fairly in generalities. See Brudno, note 8 *supra*.
37. See note 31 *supra*.
38. 38% plus the effective rate of 7.8% (100-85 dividend credit x 52%) on a $62 dividend, yields 42.84%.
39. Puerto Rico, Canal Zone, American Samoa, Wake and Midway Islands. Treas. Reg. § 1.931-1(a)(1) (1957). Section 31 of the ORGANIC ACT OF GUAM, 64 Stat. 392 (1950), 48 U.S.C. § 1421i(a) (1958), treats Guam as a territory for income tax purposes; § 931 has no application.

possessions; and (2) 50 percent or more of its gross income from the active conduct of a trade or business within the possessions.[40]

However, the form of the tax preference granted a Possessions Corporation is materially different than the "14 point" deduction available to the Western Hemisphere Trade Corporation; the Possessions Corporation, though a domestic corporation, is not subject to United States tax on its possessions' and foreign source income. In other words, although a hybrid form it has substantially the same deferral status as a foreign corporation.

The original policy justification for the grant of tax deferral to Possessions Corporations appears to be based on the same competitive considerations prompting the concession granted Western Hemisphere Trade Corporations, with perhaps the added purpose of encouraging United States investment in its possessions. In any event, the possessions legislation preceded the Western Hemisphere Trade Corporation legislation by some twenty years, and originally related to the competitive position of American branch operations with British and French interests in the Phillipines.[41]

B. TAX ADVANTAGES

As suggested above, a Possessions Corporations is a tax hybrid; Congress has endowed this legal form with some of the normal attributes of both ordinary domestic corporations and foreign corporations. These attributes are more fully outlined below where possessions operations are compared with ordinary domestic corporations, foreign subsidiary operations, and Western Hemisphere Trade Corporation operations.

1. *Possessions Corporation vs. Ordinary Domestic Corporation.* The immediate tax benefits of a Possessions Corporation in a United States possession may be quite substantial as compared with an ordinary domestic corporation. Possessions and foreign source income (20 percent or less) is not subject to United States tax unless paid in the United States; since tax rates in the possessions are generally lower than in the United States, a Possessions Corporation usually enjoys an immediate rate advantage over an ordinary domestic corporation. In the case of business operations in Puerto Rico, the advantages of a Possessions Corporation qualifying under the Puerto Rican tax incentive legislation may extend to the point of the difference between the United States tax burden on the ordinary domestic corporation and no tax at all under the tax holiday provisions in Puerto Rican law. However, in the latter case, when the Possessions Corporation remits to a United States parent, there would be no credit available for possessions tax, and the tax advantages to the extent of the remissions would be eliminated.

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40. Section 93. The benefits of § 931 are also available to individuals, *e.g.*, a possessions business conducted in proprietorship or partnership form.

41. See Surrey, *supra* note 34, at 831-32.

Apart from deferral, in most other respects a Possessions Corporation is treated as an ordinary domestic corporation as is discussed below.

2. *Possessions Corporation vs. Foreign Subsidiary.* Because of tax deferral and the availability of indirect credit for possessions and foreign income taxes, a Possessions Corporation stands on a substantial parity with a foreign subsidiary.[42] And like a foreign subsidiary, a Possessions Corporation has the same freedom from the risks of the penalty tax imposed on accumulated earnings. And, of course, except for the necessity of avoiding payment of its income in the United States, the Possessions Corporation is no less burdened than the foreign subsidiary as respects choice of operating methods.

However, unlike a foreign corporation, a Possessions Corporation retains a number of the advantages of an ordinary domestic corporation. Thus, for example, a Possessions Corporation may be formed, reorganized, or liquidated tax free into a United States parent, without the necessity of a prior ruling from the Service under section 367.

3. *Possessions Corporation vs. Western Hemisphere Trade Corporation.* In dealing with business operations in the United States possessions in the Western Hemisphere (Puerto Rico and the Canal Zone), meaningful comparisons with Western Hemisphere Trade Corporation operations can be made only on the basis of considering dividend remissions. For example, assume the use of both legal forms as Puerto Rican subsidiaries where all earnings are distributed; the parent's tax burden in this case is substantially similar. The United States parent of a Possessions Corporation would include the full amount of ordinary dividends in income without the 85 per cent dividend received credit,[43] but with full credit for the Puerto Rican withholding tax on dividend remissions, resulting in a 52 percent tax burden. Although the United States tax burden on a Western Hemisphere Trade Corporation in a similar situation, as demonstrated above,[44] would ostensibly amount to but 42.8 percent, when the Puerto Rican withholding tax of 30.45 percent on dividend remissions is used most effectively, as a deduction in this case, the combined tax burden amounts to 51.9 percent.[45]

However, in other respects the use of a Possessions Corporation results in some tax advantages over Western Hemisphere Trade Corporation operations. Possession qualification permits a greater latitude with respect to investment income since only 50 percent of gross income must be from a trade or business as against 90 percent for a Western Hemisphere

42. A corporation organized under Possessions law is a foreign corporation; § 7701(a)(4), note 2 *supra*, defines a domestic corporation as including one organized in a "territory," a term which does not embrace a United States possession.

43. Section 246(a)(2)(B). The disallowance, of course, springs from the deferral privilege of the Possessions Corporation; similarly, individuals do not have the benefits of the dividend exclusion and credit against dividends received from Possessions Corporations. Sections 34(c), 116(b).

44. Note 38 *supra*.

45. See Brudno, *supra* note 12, at 180.

Trade Corporation. Also, there are ordinarily no risks from the accumulated earnings tax or collapsible corporation limitations operating in Possessions form, and a Possessions Corporation may be liquidated tax-free under section 322 into a United States parent thereby bringing home tax-deferred income for further sheltering by the parent.[46]

VI. CHINA TRADE ACT CORPORATIONS

A. IN GENERAL

Perhaps the preferential treatment accorded income from the third geographic area, now Hong Kong and Formosa, deserves little more than a footnote reference because of the limited application of the China Trade Act Corporation provisions. It is understood that there are but seven such federally chartered domestic corporations currently in active business. However, the technique employed by Congress in granting the tax preference, and the policy justifications would appear desirable of description in any survey of legal forms available for use in international trade and investment.

In granting the tax concession under the China Trade Act, the gross income and trade or business approach of the Western Hemisphere Trade Corporation and Possessions Corporation provisions is not used at all; instead, a domestic corporation may qualify for China Trade Act Corporation status simply by being chartered under the China Trade Act of 1922 in the District of Columbia.[47] However, China Trade Act Corporation status does not, per se, provide the tax preference, although when the statutory criteria are satisfied, the effect is the exemption of Hong Kong and Formosa source income in the hands of both the corporations and its Hong Kong and Formosa resident shareholders.

The corporate exemption from United States tax is provided through the technique of a "special deduction." Thus, while the corporation, as a domestic corporation, is subject to United States tax on its income as earned, it is granted a "special deduction" from gross income for limited amounts of gross income. The amount of the "special deduction" is limited in two ways. First, it is limited to the amount of the Hong Kong and Formosa source income times a fraction whose numerator is the par value of shares held by Hong Kong, Formosa, United States, United States Possessions residents, and United States citizens, and whose denominator is the par value of all outstanding shares. Second, the amount of the "special deduction" is limited by a rule providing that the reduction of tax liability by reason of the deduction may not exceed the amount of a "special dividend" which must be certified by the Secretary of

46. If the Possessions Corporation has been operating tax-free under the Puerto Rican exemption program, the accumulated earnings may thus be used by the parent although never having been subject to tax.
47. Section 941(a).

Commerce to the Commissioner.[48] The Regulations provide the example of gross income of a China Trade Act Corporation of $200,000, owned 100 per cent by qualifying residents and citizens, subject to corporate tax of $98,500, but having declared a certified special dividend of $100,000. In this case, since the special dividend exceeds the tax liability, the corporation would be free of United States tax.[49] In short, the Hong Kong and Formosa source income of a China Trade Act Corporation is exempt from tax, as distinguished from the rate reduction accorded Western Hemisphere Trade Corporations and tax deferral accorded Possessions Corporations.

The second tax preference of the China Trade Act provisions is granted to shareholders of China Trade Act Corporations resident in Hong Kong and Formosa, dividends received by such individuals being exempt from tax;[50] non-qualifying shareholders, for example, a United States resident,[51] would be subject to the normal 30 percent withholding.[52]

The historical basis for the foregoing tax preferences is again, as in case of the Western Hemisphere Trade Corporation and Possessions Corporation, to be found in the alleged need to meet the competition of companies formed in other capital exporting nations, especially England, and the requirement of a federal charter is seemingly responsive to the inability of the Chinese investor to understand or work within the framework of a federal system with its multiple corporation laws.[53]

B. TAX ADVANTAGES

The present limited scope of the China Trade Act provision renders a detailed outline of the tax advantages of a China Trade Act Corporation impractical. However, the advantages of a China Trade Act Corporation over an ordinary domestic corporation are obvious. The tax advantages over a foreign corporation might depend in large measure on dividend policy. However, although in the ideal China Trade Act Corporation tax situation, full corporate exemption is granted, the price of the exemption requires a passing on of the tax savings to the shareholders; in the case of a domestic United States parent this requirement might be too impractical in many situations. Also, the China Trade Act requires that the corporate president, treasurer and majority of the board be American citizens resident in Hong Kong or Formosa; this means that at least two American citizens must

48. Section 941(b); for a description of the administration of the China Trade Act by the Bureau of Foreign Commerce, see BITTKER & EBB, TAXATION OF FOREIGN INCOME 339 (1960).
49. Treas. Reg. § 1.941-3 (1957). A China Trade Act Corporation is not allowed foreign tax credit. Section 942.
50. Section 943.
51. The individual dividend exclusion and credit is not available against such dividends. Sections 34(c), 116(b).
52. See Treas. Reg. § 1.943-1 (1957).
53. See Shere, *Taxation of Business Abroad*, N.Y.U. 7th INST. ON FED. TAX 812, 819 (1949).

be maintained abroad.[54] The foregoing restrictions perhaps have contributed to the limited effectiveness of the legislation. One writer, for example, relates that although the China Trade Act preference was made available in 1922, by 1940 "less than 4 percent of the United States direct investment in China [prior to the restriction to Hong Kong and Formosa] was in China Trade Act companies," concluding that the tax preference has not contributed significantly to Chinese-American trade.[55]

VII. Foreign Business Corporations (Proposed)

A. in general

A fourth geographic area, a variable one consisting mostly of the land mass below the Tropic of Cancer, has been surveyed by Congress for possible additional tax concessions: the "less-developed" country. The proposed new concession, contained in the Foreign Investment Incentive Tax Act of 1960 (Boggs Bill—H.R.5) of the 86th Congress, died in the Senate after House passage on May 18, 1960. However, presumably, the bill, or some form thereof, will be introduced in the 87th Congress in 1961. Although the narrow margin (195-192) by which the bill cleared the House suggests the present form is but a preliminary draft, the general features of the bill are worth description if for no other reason than that they reveal a shift in congressional policy towards tax concessions to foreign trade and investment.

The most significant proposal of the legislation is the provision made for a new type of domestic corporation, the Foreign Business Corporation,[56] which will be permitted to defer its "less-developed" country business income from United States tax until this income is distributed or is deemed distributed. The technique by which the tax deferral concession is granted is not unlike that used with respect to Western Hemisphere Trade Corporations and Possessions Corporations. Thus, tax deferral is limited to domestic corporations electing to be treated as Foreign Business Corporations and meeting certain tests. The three most basic tests require (1) 90 percent of the corporation's gross income be derived from sources within "less-developed" countries; (2) 90 percent of the gross income must emit from one or more of four types of income, including "less-developed" country business income, earned directly or indirectly through foreign subsidiaries, and a limited amount (up to 25 percent of gross income) of income from service functions, franchises, patents and similar

54. See Bittker & Ebb, *op. cit. supra* note 48.
55. Shere, note 53 *supra*.
56. Other significant provisions are: (1) the removal of certain § 367 and § 1491 transactions from the exclusive jurisdiction of the Service (see note 13 *supra*); and (2) provision for the recognition of gain or loss upon the transfer of inventory to foreign corporations and Foreign Business Corporations.

property; and (3) that not more than 10 percent of gross income consist of income from imports.[57]

A "less-developed" country is defined as "any foreign country (other than an area within the Sino-Soviet bloc)" or United States possession which is so designated by the President. However, the proposed act expressly denied designation to certain countries, mostly in Western Europe, and Japan and Canada,[58] although the legislative history of the bill indicates that an "overseas department, province or possession" of an excluded country could be designated a "less-developed" country.[59]

From a policy viewpoint the principal purpose of the proposed law as originally reported by the Ways and Means Committee was "to bring the tax treatment for foreign operations carried on through United States corporations more nearly in accord with that applicable where foreign subsidiaries are used."[60] And the terms of the act permit the use of a domestic Foreign Business Corporation as a domestic base company in the same manner that foreign corporations are used under existing law.[61]

However, additional policy purposes are implicit in the amendment to the reported bill made on the floor of the House limiting the tax deferral privilege to income from "less-developed" countries. This limitation can be regarded as expressive of a policy to aid actively the economic development of such nations through the mechanism of the Internal Revenue Code. Further, the conditions of qualification as a Foreign Business Corporation reveal a detailed congressional articulation of a policy limiting an income tax concession to situations when there has been a substantial economic penetration of "less-developed" countries.

B. TAX ADVANTAGES

There appears to be a good likelihood that some form of the proposed Foreign Business Corporation provisions will be enacted in the near future; however, it cannot be assumed that the legislation will conform in detail to the Boggs Bill as passed by the House in May, 1960. Therefore, only

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57. The following are expressly excluded from qualifying as Foreign Business Corporations: tax exempt organizations, China Trade Act Corporations, Regulated Investment Companies, life insurance companies, personal holding companies, section 1361 corporations, and subchapter S corporations; special provision is made for foreign branches of banks. Also, a corporation will not be eligible for Foreign Business Corporation status if the Secretary of Labor determines that the corporation has operated in any less-developed country under substandard labor conditions. H.R. 5, 86th Cong., 1st Sess. § 951(f) (1959). For a discussion of the procedures to be taken by the Secretary, see 106 CONG. REC. 9825-26 (1960).

58. H.R. 5, 86th Cong., 1st Sess. § 951(e) (1959).

59. 106 CONG. REC., note 57 *supra*.

60. H.R. 1282, 86th Cong., 2d Sess. 1 (1960). The reported bill also proposed the removal of the effect of § 902 (computation of the foreign tax credit of a United States parent on dividend remissions from a foreign corporation, note 28 *supra*) by requiring foreign source income to be "grossed-up"; the "gross-up" provision was removed on the floor of the House and the problem is being considered in separate legislation. Note 30 *supra*.

61. See note 19 *supra*.

the broad outlines of the possible tax advantages of a Foreign Business Corporation over other available forms will be attempted here.

1. *Foreign Business Corporation vs. Ordinary Domestic Corporation.* When a United States corporation is presently engaged in business operations or planning operations in "less-developed" countries, the proposed legislation provides the deferral and base company advantages of a foreign corporation and in these respects would be preferable to an ordinary domestic corporation. In addition, a 100 percent intra-corporate dividend received credit is allowed a United States parent against dividends received from 80 percent controlled Foreign Business Corporations,[62] as distinguished from the limited 85 percent deduction against similar dividends from ordinary domestic corporations.

With reference to comparable tax treatment with foreign branch income, section 953 of the proposed act prescribes detailed rules of accounting with respect to income from "less-developed" countries. This income must be recorded, unreduced by foreign taxes paid, in a separate "reinvested foreign income [less-developed country] account." Upon distribution, a tax is imposed on the amount of the distribution plus the higher of United States tax attributable to the distribution or the tax allocable to the distribution from the "less-developed" countries. In the foregoing manner, the United States tax burden on income from "less-developed" countries is equated with foreign branch income.[63]

2. *Foreign Business Corporation vs. Foreign Subsidiary Operations.* Some of the more difficult tax planning problems will undoubtedly center around the relative tax advantages of the use of Foreign Business Corporations and foreign corporations in "less-developed" country operations. The method of producing foreign source income may be determinative of the choice in some cases. For example, where substantial amounts of "less-developed" country income would consist of income from management or technical services or from licensing agreements, qualifications as a Foreign Business Corporation may not be possible under the requirement that limits the amount of this income to 25 percent of gross income. Similarly, disqualification would result where 10 percent or more of a Foreign Business Corporation's gross income is derived from imports. And substantially the same restrictions are imposed with respect to remissions from a Foreign Business Corporation's subsidiaries.

In addition to the foregoing, the tax planner contemplating the use of a Foreign Business Corporation will probably find it necessary to establish extensive internal controls in order to ensure continued qualification and to avoid constructive distribution of Foreign Business Corporation

62. H.R. 5, 86th Cong.. 1st Sess. § 2(b)(1) (1959).

63. However, a Foreign Business Corporation is expressly excluded from qualifying for membership in an affiliated group, precluding participation in a consolidated return. H.R. 5, 86th Cong., 1st Sess. § 2(e) (1959).

income which would invoke United States tax.[64] Assuming that the hurdle of adequate internal controls can be surmounted, the principal tax advantages of a Foreign Business Corporation over a foreign subsidiary would appear to lie in the greater freedom found in forming, reorganizing, and liquidating Foreign Business Corporations and their subsidiaries than current law permits under sections 367 and 1491 with respect to foreign subsidiaries. Subject to certain limitations, proposed amendments to sections 367 and 1491 would permit the formation of a Foreign Business Corporation with the assets of foreign corporations and branches, and would permit similar formations of Foreign Business Corporation subsidiaries, without prior clearance from the Service.[65]

3. *Foreign Business Corporation vs. Western Hemisphere Trade Corporation.* Assuming that the Latin countries will be designated as "less-developed," the principal tax advantage of the proposed Foreign Business Corporation over a Western Hemisphere Trade Corporation would be that of tax deferral as against a present lower corporate rate of tax imposed on the latter's income. Also, as noted above, a United States parent would not be subject to the intra-corporate dividend tax of 7.8 percent functioning through a Foreign Business Corporation subsidiary. However, it is worth noting that the price of deferral will ordinarily require that substantially all a Foreign Business Corporation's assets and payroll be located within "less-developed" countries; as regards export operations this may be a price that many exporters presently operating in Western Hemisphere Trade Corporation form would be unwilling to pay.

4. *Foreign Business Corporation vs. Possessions Corporation.* The principal tax advantage of a Foreign Business Corporation over a Possessions Corporation, both domestic corporations with a deferral privilege, would appear to lie in the use of a Foreign Business Corporation as a base company. The Possessions Corporation with its requirements of 80 percent of gross income from United States possessions and 50 percent from a trade or business, is limited in use as a base company. On the other hand, one of the basic purposes of the proposed Foreign Business Corporation legislation is to permit the use of these companies as base companies.[66] This is reflected in the proposed amendments to section 367 noted above, as well as in the provision permitting dividends and other income from certain

64. In addition to ordinary dividend distributions and distributions in redemption of stock, three types of transactions are characterized as constructive distributions: (1) a portion of business income when "less-developed" country investment and payroll drop below 90% of such totals; (2) holdings of property except property used in the business and certain other property; and (3) certain types of loans to parent corporations. H.R. 5, 86th Cong., 1st Sess. § 954 (1959).

65. H.R. 5, 86th Cong., 1st Sess. § 367(b), (c) (1959) a proposed amendment to § 1492 would permit the transfer of stock or securities by a Foreign Business Corporation to a foreign corporation as a capital contribution free of the § 1491 excise tax. Also, special provision is made for carry over of the reinvested foreign income account of an old Foreign Business Corporation to a new Foreign Business Corporation in reorganization.

66. See H.R. 1282, 86th Cong., 2d Sess. 15 (1960).

Foreign Business Corporation subsidiaries to qualify as gross income under the 90 percent rule.[67]

VIII. Foreign Investment Companies

A. in general

As discussed above, traditionally, Congress has asserted tax jurisdiction over foreign corporations only on their United States source income. As a result, United States corporations have made substantial use of foreign corporations in carrying on overseas trade and in making direct foreign investments. The same jurisdictional limitations have also tempted individuals to use the foreign corporation as an investment company to shelter portfolio and similar foreign investments.[68]

However, in subchapter G of the Code, Congress has imposed a number of important statutory restraints on potential tax avoidance that limit, in some measure, the use of a foreign investment company.[69] In the first place, a foreign investment company may be subject to the penalty tax on accumulated earnings, the statute expressly providing that investment company status is prima facie evidence of the prohibited statutory purpose to avoid the personal income tax imposed on the shareholders.[70] On the other hand, the penalty tax is imposed only on accumulated taxable income, and taxable income of a foreign corporation is limited to income from United States sources.[71] Thus, when the foreign investment company is without United States source income, such as where its income is from foreign securities or from property used or exploited in foreign countries, the accumulated earnings tax would have no application and pose no threat.

A second limiting factor in the use of a foreign investment company may be found in the Personal Holding Company tax imposed on "undistributed personal holding company income" of qualifying closely held

67. See text note 57 *supra*. The technique adopted is that qualifying income of a Foreign Business Corporation may include dividends and other income from a "qualified payor corporation," in which the Foreign Business Corporation has a 10% or more stock interest; a "qualified payor corporation," which may be either a domestic or foreign corporation, must meet tests similar to a Foreign Business Corporation, have 80% or more of its assets and payroll in "less-developed" countries, and derive 50% or more of its gross income from the active conduct of a trade or business in "less-developed" countries.

68. Foreign portfolio investment may be made directly, of course, by purchase of foreign securities on United States or foreign exchanges, or indirectly through domestic investment companies. Certain domestic investment companies (and mutual funds), and Regulated Investment Companies are accorded special treatment by the Code under which the entity is subject to tax only on undistributed income; where 50% of such corporation's total assets consist of stock or securities in foreign corporations, and other conditions are met, the corporation may elect to be treated as a conduit for purposes of passing credit or deductions for foreign income taxes through to the shareholders. Sections 851-55.

69. For a more detailed discussion see Rado, *Foreign Investment Companies and Subchapter G Penalties*, 35 Taxes 423 (1957).

70. Section 533(b).

71. See note 23 *supra*.

domestic or foreign corporations.[72] The foregoing penalty tax (75 percent on the first $2000 and 85 percent on the balance of undistributed income) is designed to force a distribution of current earnings. However, a foreign investment company without United States source income would not be subject to the penalty tax, nor would the tax be imposed when the corporation is widely held and thus fails to meet the stock ownership test which requires 50 percent stock ownership in five or fewer unrelated individuals.

A third and more important restraint on the use of a foreign investment company is that imposed by the Foreign Personal Holding Company provisions.[73] Under the terms of the foregoing legislation, United States shareholders must include in gross income their pro rata share of their Foreign Personal Holding Company's "undistributed foreign personal holding company income," whether distributed or not.

A Foreign Personal Holding Company itself is subject to United States corporate tax on its United States source income on the same basis as other foreign corporations, depending on its status as resident or non-resident;[74] although for purposes of the gross income test discussed below, a Foreign Personal Holding Company is treated as a domestic personal holding company.[75] However, the technique by which the expanded jurisdiction over the undistributed income of United States shareholders is exerted has made necessary a complex and detailed set of rules pertaining to both the corporation and its shareholders.[76]

The rules pertaining to the corporation determine its status as a Foreign Personal Holding Company. Thus, a foreign corporation is a Foreign Personal Holding Company only if it meets two tests pertaining to its gross income and the number of its United States shareholders. Under the gross income requirement, 60 percent or more of the gross income of the corporation must consist of "foreign personal holding company income," which includes such investment type income as interest, dividends, royalties, and gain from security sales.[77] Once a foreign corporation is classified as a Foreign Personal Holding Company, the foregoing percentage requirement drops to 50 percent, and the 50 percent test must be met for three successive years to regain the basic 60 percent figure.

Under the stock ownership test more than 50 percent in value of the corporation's stock must be owned directly or indirectly by not more

72. Sections 541-47.
73. Sections 551-58.
74. Treas. Reg. § 1.552-1(b) (1958).
75. Section 555.
76. Section 551 contains the basic rules pertaining to the amount includible in gross income, the pass-through rules of partially tax exempt interest, information return requirements of shareholders, the basis adjustment rules, and the effect on the capital account of the corporation.
77. Section 553, adopting, with some additions, the definition of § 543 pertaining to domestic personal holding companies.

than five United States citizens or residents. However, constructive ownership rules, applicable to both Personal Holding Companies and Foreign Personal Holding Companies, may result in attribution of stock ownership to an individual from a corporation in which he has an interest, a partner, or from a family member.[78]

On the basis of the foregoing, a foreign investment company will not be subject to either the Personal Holding Company or the Foreign Personal Holding Company provisions when there is a proper dispersal of stock ownership. In actual practice, dispersal of stock ownership is the normal technique by which the Foreign Personal Holding Company provisions are avoided, and limiting the foreign investment company's income to foreign sources normally avoids the application of both the Personal Holding Company tax and the accumulated earnings tax.

B. TAX ADVANTAGES

Assuming the subchapter G measures discussed above are properly avoided, a foreign investment company may provide a United States citizen or resident with substantial tax advantages. The principal advantage, of course, is that this investment vehicle permits the deferral, and in some instances avoidance, of the United States personal income tax imposed on dividend income at rates ranging up to 91 percent.[79] Thus, when a foreign investment company accumulates its income, its United States shareholders would be subject to tax on the accumulations only at capital gains rates upon the sale or liquidation of the corporation. And when the shares are held until death of the shareholders, all United States taxes are avoided up to date of death through the stepped-up basis acquired by the heir or legatee.[80]

The foregoing tax advantages, of course, require an appropriate tax climate in the country of incorporation, and, as a practical matter, suitable investment opportunities for the foreign investment company. The latter sometimes may be found in the United States security and commodity markets, although when capital-importing countries have designed their revenue laws to encourage their own development, the maximum foreign tax advantages will ordinarily be found to exist when the foreign investment company invests in the country of its incorporation.

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78. The stock ownership tests of both Personal Holding Companies and Foreign Personal Holding Companies would not be met where there are ten or more unrelated shareholders each owning no more than 10% of the shares. Sections 544, 554. A publicly held United States domestic corporation owning or controlling a foreign corporation meeting the gross income test of a Foreign Personal Holding Company would not meet the stock ownership test. See Brainerd, *United States Income Taxation of the Foreign Holding Company*, 34 TAXES 231, 245-47 (1956).

79. Although foreign withholding taxes imposed on dividend remissions of foreign corporations would ordinarily be subject to foreign tax credit, no credit is allowed to individuals for foreign income taxes paid by the corporation, nor is the $50 dividend exclusion and 4% dividend received credit available.

80. Section 1014.

United States investors perhaps are best acquainted with the foreign tax status of an investment company incorporated in Canada, although the corporation and tax laws of lesser known nations may also provide substantial overall tax advantages.[81]

When a foreign nation has established special tax legislation for treatment of investment companies, a choice of forms from the standpoint of foreign law may exist. This is the situation in Canada; under the Canadian Income Tax Act, a Canadian investment company may elect to be treated as a Nonresident Owned Company, which is subject to a flat 15 percent tax without deduction for dividends received from Canadian companies, or as an ordinary Canadian corporation subject to a marginal tax rate of 50 percent (includes a 3 percent old age security tax), but with a 100 percent deduction for dividends received from Canadian corporations.[82]

IX. FOREIGN SITUS TRUSTS

A. IN GENERAL

From the standpoint of the jurisdictional entity pattern of the Internal Revenue Code, the status of trusts (and estates) is unique. Only indirectly does the Code recognize a foreign trust as a taxable entity, and only by usage and ruling has it acquired a recognizable status as a nonresident alien individual within the framework of the Code. Thus, lacking specific Code direction, the Regulations simply provide that the term "nonresident alien individual . . . includes a nonresident alien fiduciary," taxable under the Code when not engaged in business in the United States on his United States source investment income (except interest from United States bank deposits).[83]

Although foreign situs trusts have fallen into the category of nonresident alien individuals, usage and rulings have yet to provide reliable criteria by which a foreign situs trust is to be characterized as foreign rather than domestic. There would be little doubt as to a characterization when all the factors or contacts — settlor, trustee, corpus and income, beneficiary — are either foreign or domestic. However, when the factors

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81. See *e.g.*, Rado, *Tax Advantages of Investment and Holding Companies in the Netherlands Antilles*, P-H TAX IDEAS ¶ 8034 (1958); Pine & Graham, *Bermuda — A Base For Foreign Business and Investment*, P-H TAX IDEAS ¶ 8056 (1960).

82. For a comparative analysis see Seiden, *Tax Aspects of Canadian Investment Companies*, 4 CAN. TAX J. 290 (1956).

83. Treas. Reg. § 1.871-2(a) (1957). Foreign situs trusts are dealt with in four Code provisions: (1) § 402(c), dealing with the taxability of beneficiaries of certain foreign situs employee trusts created or organized outside the United States; (2) § 643(a)(6), defining distributable net income of a trust as including the foreign income of a foreign trust; (3) §§ 1491, 1493; the former imposing a 27.5% excise tax on transfer of appreciated stock or securities to foreign entities, including foreign trusts, and the latter section defining a foreign trust in terms of one outside the United States where gain from the sale of such securities would not be included in the trust's gross income, presumably for want of a United States source; and (4) § 7456(b), dealing with the power of the Tax Court to order the production of records including those of a foreign trust or estate.

are divided, the problem is more difficult. The traditional position of the Service appears to have centered on the place of creation, perhaps by analogy to the statutory approach to domestic and foreign corporate status, regarding the place of creation as the nation whose laws would govern the essential validity of the trust instrument. Thus, *I.T. 1885*,[84] issued in 1923, involved a testamentary trust of a Canadian decedent-resident and a Canadian fiduciary holding both Canadian and United States property and maintaining a United States collection office; the trust was characterized as a nonresident alien subject to tax only on its United States source income. The ruling rationalized that when a trust "owes its existence" to foreign law it is to be treated as a nonresident alien irrespective of the status of the fiduciary.[85]

However, the Service has recently modified the broad stand taken in *I.T. 1885* that the place of creation controls characterization. *Revenue Ruling 60-181*[86] involved a testamentary trust of a nonresident alien with nonresident alien beneficiaries, but with a United States trustee actively administering a corpus primarily of securities of United States corporations; the trust was held to be a resident alien. Therefore, it would seem that the place of creation rule still obtains as regards domestic or foreign status, but residency will be determined on the basis of administration and activity of the trustees.

If the foregoing is correct, the new ruling probably provides a fresh blueprint for the tax planner in securing the multiple tax advantages, outlined below, of the foreign situs trust in family estate planning. However, the tax planner should also have his eye on Congress and possible Treasury recommendations to curb the use of foreign situs trusts. Perhaps a harbinger in the foregoing respect is to be found in the proposed amendments to H.R. 9662 (Trust and Partnership Income Tax Revision Act of 1960) made by the Senate Finance Committee in June, 1960. Although the bill failed to pass (primarily because of the lack of time to work out details of proposed changes dealing with multiple trusts), the proposed amendments indicate a congressional awareness that foreign situs trusts have been subject to abuse. Broadly, the proposals, which are discussed below, would have made the use of a family foreign situs trust less desirable both as an income splitting device and as a tax avoidance device.

B. TAX ADVANTAGES

Under the present revenue laws of the United States, there are few devices available that compare to the foreign situs trust as a vehicle for

84. I.T. 1885, II-2 CUM. BULL. 164 (1923); see also REV. RUL. 57-245, 1957-1 CUM. BULL. 286, holding that ancillary administration in the United States of a foreign estate does not change the status of the foreign estate from that of a nonresident alien.

85. It does not follow that characterization as a nonresident alien individual constitutes a rejection of a foreign trust or estate as a separate tax entity. See rulings note 84 *supra*.

86. REV. RUL. 60-181, 1960-1 CUM. BULL. 257.

both deferring and avoiding United States tax on United States citizens and residents. These tax advantages flow from two main sources in the Code: the limited tax liability of a nonresident alien, and the basic rules governing the allocation of trust income between trust and beneficiary. Thus, assuming the usual situation of a United States settlor and United States beneficiaries, the creation of a foreign situs accumulating or discretionary trust with foreign trustees (preferably corporate without United States affiliation) and a trust instrument that avoids the *Clifford* rules, the following tax advantages may exist:[87] (1) the trust is not subject to United States capital gains tax on the disposition of capital assets even where effected in the United States; (2) the trust is exempt from United States tax on interest income from United States bank deposits; (3) the trust is exempt from United States tax on its foreign source income; and (4) under certain circumstances, the tax exempt accumulated income and gains of the trust may be distributed tax-free to a United States citizen or resident beneficiary.

The first three of the foregoing tax exemptions have their source in the Code rules governing the taxation of nonresident aliens;[88] the fourth exemption is a consequence of those subchapter J rules governing the attribution of trust income between an accumulating ("complex") trust and its beneficiaries. Broadly, in order to prevent tax avoidance through income splitting between trust and beneficiary, section 665 of the Code prescribes a "throwback" rule under which certain distributions of accumulated income are treated as if distributed in prior years. The effect of the "throwback" rule, which is applied to five preceding years, is to shift the tax incidence from the trust to the beneficiary; the beneficiary is subject to tax on the trust's distributions to the extent of the "distributable net income" (generally, taxable income plus important modifications) of the trust. Thus, the key to the tax treatment of both the trust, since it receives a special deduction for distributions up to its distributable net income, and the beneficiary, is the "distributable net income" concept. Under present law, the foreign source income of a foreign trust is includible in distributable net income,[89] as well as United States source capital gains to the extent allocated to income under the trust instrument.[90] The foregoing income is subject to the "throwback" rule and imposition of tax on the United States beneficiaries. Therefore, although such income is not subject to United States tax in the hands of the foreign situs trust, as it would be in the hands of a domestic trust, the tax benefits are limited to deferral of tax; avoidance of tax is prevented by application of the "throwback" rule.

87. For a more extended discussion of the tax advantages of foreign trusts see Altman & Kanter, *Senate Finance Committee Looks at Foreign Situs Trusts*, 38 TAXES 585 (1960); Pine & Stock, *Tax Advantage of Foreign Trusts*, P-H TAX IDEAS ¶ 8050 (1959); Hammerman, *IRS Clarifies Foreign-Situs Trusts as Bill to End Some Tax Benefits Dies*, 13 J. TAXATION 199 (1960).
88. Sections 871-77.
89. Section 643(a)(6), note 83 *supra*.
90. Section 643(a)(3).

However, the Code provides a number of important exceptions to the "throwback" rule:[91] (1) amounts not in excess of $2,000; (2) distributions accumulated before a beneficiary reaches twenty-one; (3) distributions to meet emergency needs of a beneficiary; and (4) a terminating distribution of all trust assets in a lump sum made more than nine years after the date of the last transfer into trust.

It is primarily the tempered use of the foregoing exceptions to the "throwback" rule, permitting the tax-free distribution of untaxed income (except for any foreign tax) in the hands of the trust, which has made the foreign situs trust so attractive as a tax avoidance device. However, as previously indicated, there is handwriting on the walls of the congressional chambers indicating that statutory limitations may soon be imposed on the use of the foreign situs trust. The proposed Senate Finance Committee amendments to H.R. 9662 of the 86th Congress would bring untaxed United States source capital gains into distributable net income subject to the "throwback" rule; it would also eliminate the exceptions to the "throwback" rule outlined above.[92] It will be recalled that foreign source income is currently includible in distributable net income. The proposed changes would have applied only to foreign situs trusts established by United States grantors for United States beneficiaries. The proposed amendments, however, would not appear to prevent tax avoidance through five year aging and deferral, thereby avoiding the application of the "throwback" rule; in short, it would seem that the "throwback" rule itself would be required to take the strain of preventing tax avoidance.

X. THE UNITED STATES CITIZEN ABROAD

An important adjunct to the tax planning of corporate foreign investment is the planning of the personal tax problems of corporate personnel sent abroad. However, the jurisdictional aspects and the Code modifications of the basic rule that subjects United States citizens (and residents) to United States tax on their world-wide income are not limited to corporate personnel; United States citizens in general have found that the Code modifications provide some decided tax advantages, especially individuals engaged in business involving the rendering of personal services.

Broadly, the Code limits the application of the rule subjecting the global income of the individual United States citizen to United States tax in three situations: (1) where he is a bona fide resident of a foreign country or countries for a taxable year, his earned income is excluded from gross income;[93] (2) where he is present in a foreign country or countries for 510 full days during any period of eighteen consecutive months, his

91. Section 665(b).
92. See S. REP. No. 1116, 86th Cong., 2d Sess. (1960).
93. Section 911(a)(1).

earned income up to $20,000 a year is excluded;[94] and (3) where he is a bona fide resident of Puerto Rico for a taxable year, his Puerto Rican source income is excluded.[95] In the above cases, deductions allocable to excluded income are not allowed, nor, of course, is credit for foreign income taxes paid.

A. BONA FIDE FOREIGN RESIDENT

The key to the exclusion of foreign source earned income under section 911(a)(1) is the requirement that the taxpayer establish that he has been a "bona fide resident of a foreign country or countries" for the requisite period.[96] While the present statutory provision has had a checkered history, the concept of "bona fide resident" has been embedded in the law since 1926;[97] however, the numerous cases and rulings dealing with the concept have provided only benchmarks rather than reliable criteria for determining the meaning of "bona fide" residence abroad. Each case has been largely a factual inquiry with the emphasis placed on such objective indicia of the taxpayer's intent as the extent to which the taxpayer uprooted himself, his family and possessions and integrated himself into the social and economic life of the foreign community. Also evidentiary has been the permanency of the work, payment of taxes to foreign countries, formal declarations of intent, and the legal status of the taxpayer in the foreign state.[98]

All courts and the Service appear to agree that the term "residence" does not mean "domicile," but they often seem to assume that "domicile" has an unvariable content. Perhaps the irreconcilable results in the cases can be attributed in some measure to a difference in approach. Thus, in *Jones v. Kyle*,[99] in denying the taxpayer, a construction worker in Saudi

94. Section 911(a)(2).

95. Section 933; the exclusion, unlike § 911, also applies to aliens (see also § 876). The exclusion of § 933 does not apply to *employees* of the United States government or of its agencies, while the § 911 exclusions do not apply to *amounts paid* by the United States government or by its agencies. However, overriding both §§ 911 and 933 are cost-of-living allowances of civilian employees stationed outside the continental United States and certain foreign service allowances of employees of the United States Foreign Service. Section 912.

While an individual United States citizen is entitled to the benefits of § 931 with respect to his trade or business income from United States possessions (notes 39, 40 *supra*), the term "possessions" does not apply to an individual in case of Puerto Rico (§ 931(c)); hence, § 933 must be relied upon in a case of a United States individual citizen doing business in Puerto Rico.

96. Although the statute provides that the exclusion is available to the taxpayer "who establishes to the satisfaction of the Secretary or his delegate" the fact of bona fide foreign residence, the Service or courts have never regarded the quoted terms, added by the 1942 Rev. Act, as granting the Service unreviewable administrative discretion. *Cf.* § 367, note 13 *supra*, where similar statutory terms do have such effect.

97. Prior to 1942 the statute referred to a "bona fide nonresident of the United States." See 8 MERTENS, FEDERAL INCOME TAXATION § 45.71 (1957).

98. For a discussion of the cases, see Newman, *Tax Administration in Striped Trousers: The International Operations Program of the Internal Revenue Service*, 12 TAX L. REV. 171, 185-90 (1957); Propp, *Problems of the Citizen Living Abroad: Requirements and Implications of Section 116* [911], N.Y.U. 12th INST. ON FED. TAX 867, 869-74 (1954).

99. 190 F.2d 353 (10th Cir.), *cert. denied*, 342 U.S. 886 (1951).

Arabia, the status of a foreign resident, the court pointed out that a statutory provision granting an exemption from tax is to be strictly construed. On the other hand, other courts appear to have taken a more liberal view on the ground that the purpose of the exemption was to encourage the United States citizen to establish foreign residence in order to aid the overseas development of American enterprise.[100]

A second major problem area under both the bona fide residence provision and the 510 day rule, discussed below, pertains to the scope of the exemptions as limited to earned income. Section 911(b) defines earned income primarily in terms of wages, salaries and fees, expressly excluding distributions of earnings and profits but permitting up to 30 percent of the income of a trade or business to be characterized as earned income when both services and capital are material income-producing factors.[101]

The tax advantages of the exemption of all earned income qualifying under section 911(a)(1) can be quite extensive when residence is established in a country with a low personal income tax. And it is understood that the major overseas corporate investors regard the foregoing aspect of tax planning as an important phase of the their personnel policies.

B. THE 510 DAY PRESENCE RULE

The 510 day presence rule of section 911(a)(2), which was established in 1951, was primarily the product of a strict construction of the bona fide residence concept by the Service and the courts, and the felt need for a tax concession for technicians under the then current administration's technical aid (Point 4) program;[102] the $20,000 ceiling on excludable earned income was imposed in 1953 because it was believed that the previous rule had been abused by high salaried non-technicans going abroad to perform services customarily performed at home.[103]

The addition of the 510 day rule has undoubtedly reduced the pressure on the bona fide residence provision, and at the same time expanded the scope of the exemption from United States tax of foreign source earned income. Although the application of the 510 day rule presents problems of its own, its objective character has proved it to be more easily administered than the bona fide residence test.[104]

100. See, *e.g.*, Meals v. United States, 110 F. Supp. 658 (N.D. Cal. 1953).

101. Earned income also includes pension payments attributable to services rendered while a bona fide foreign resident. Rev. Rul. 55-294, 1955-1 Cum. Bull. 368.

The 30% device of § 911(b) may be compared with the approach under the family partnership rules of § 704(e) which requires a determination of the reasonable value of the services, and, as construed by the courts, attribution of the balance of earnings to capital.

102. S. Rep. No. 781, 82nd Cong., 1st Sess., 1951-2 Cum. Bull. 458, 495-96.

103. *E.g.*, movie making; see S. Rep. No. 685, 83rd Cong., 1st. Sess., 1953-2 Cum. Bull. 526, 528-29; the House bill would have repealed § 911(a)(2), but the Senate Finance Committee believed that there were "many legitimate business arrangements which necessitated sending technical personnel abroad." S. Rep. No. 685, *supra*.

104. See Newman, note 98 *supra* at 190-91 for discussion of the problems involved in applying the 510 day rule.

C. RESIDENT OF PUERTO RICO

Under section 933 of the Code, a United States citizen (or resident alien), other than a United States government or agency employee, who is a bona fide resident of Puerto Rico may exclude all Puerto Rican source income from gross income for United States tax purposes. The determination of bona fide residence is governed by the same principles applicable to section 911(a)(1),[105] but it is worth noting that the Puerto Rican exclusion is not limited to earned income as is the case under section 911(a).

The policy justifications for the special treatment of Puerto Rican residents are not altogether clear; the legislative history simply indicates that because Puerto Rico is "unique," being neither a foreign country nor an integral part of the United States, and has its own tax system, United States tax could be limited to non-Puerto Rican sources.[106] However, establishing a bona fide residence in Puerto Rico ordinarily provides few federal income tax advantages for United States citizens. The Puerto Rican individual progressive income tax has been maintained at only a notch below United States rates, and the effective rates in the middle and upper brackets (over $20,000 for married persons with two dependents) are higher than United States effective rates.[107]

XI. TAX POLICY AND IMPLICATIONS FOR TAX PLANNING

It appears quite evident that the United States Congress has never been seriously concerned with a conscious regard for asserting tax jurisdiction only on the basis of particular jurisdictional theories. Perhaps the overall approach may be regarded as essentially pragmatic based on expediency. However, the jurisdictional thrust of the federal revenue laws may be loosely classified on a tripodal basis, two legs resting on traditional notions of international jurisdiction to tax and a third grounded in loosely constructed economic policy.

The traditional bases are those of: (1) nationality, under which a domestic corporation and an alien resident are regarded as national; and (2) economic allegiance as manifested by the source of income rules and under which Congress has asserted a primary jurisdiction over United States source income and a secondary jurisdiction over foreign source income of its nationals. The third jurisdictional approach has been most often expressed in the Code in terms of exceptions to the nationality and source of income bases, and is sometimes, along with the unilateral foreign tax credit device, described in terms of the Code's concessionary structure.

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105. Regulations under both § 911 and § 933 refer to the regulations governing the question of residency for nonresident aliens under § 871. Treas. Reg. §§ 1.933-1(a), 1.911-1(a)(2) (1957).

106. See S. REP. No. 2375, 81st Cong., 2d Sess., 1950-2 CUM. BULL. 483, 519.

107. See table of comparative rates and tax burdens in Friedman & Silbert, *Tax Advantages of Doing Business in Puerto Rico*, P-H TAX IDEAS ¶ 8009.7 (1955).

However, whenever Congress has provided concessions, such as special treatment for Western Hemisphere Trade Corporations, Possessions Corporations, China Trade Act Corporations, and foreign residence abroad, it has done so primarily on the ground that foreign competition for particular foreign markets has justified special treatment to the United States nationals competing for such markets. Presumably, Congress has regarded these concessions as but expressions of its foreign economic policy. And the legislative history of the various concessions reveals that Congress, at least up to the end of World War II, was often willing to deviate from both traditional theory and tax equality when it became convinced that United States interests so required.

Deviation from traditional jurisdictional notions, in fact, may be regarded as the main current in tax legislation pertaining to foreign trade and investment from the earliest revenue acts to the present. Unfortunately, however, though the main current in international tax jurisdiction is to be found less in traditional theories and more in foreign economic policy, the policy has been expressed in terms so general as to be almost indistinguishable even in outline.

Nevertheless, the foregoing is the matrix in which the tax planner must perform. In his concern with the practical necessities of advising on the form foreign trade and investment should take, and in establishing internal controls, he must be ever mindful of inarticulate congressional policy. In many areas, policy has been expressed in such general terms that planning based simply on statutory and judicial rule becomes most hazardous. A good example of this is the current controversy over the export earned dollar of the Western Hemisphere Trade Corporation which has not made a substantial penetration of a foreign economy, where the exporter is relying simply on the technical niceties of title passage at foreign port of entry for characterization of income as being from a foreign source. This particular judicial battle may be won eventually by the taxpayer;[108] however, it is possible that judicial rejection of the position of the Service, requiring economic penetration by a Western Hemisphere Trade Corporation, may be followed by additional battles at the legislative level. Of course, how difficult it would be for the Treasury to convince Congress that the present concessions to export earnings should be withdrawn is another matter. The exporters would not go without adequate representation.[109]

Perhaps of overriding importance from the standpoint of tax planning is the fact that legislative developments during the past decade make it clear that Congress is more mindful of the policy implications of

108. For recent taxpayer victories, see A. P. Green Export Co., 284 F.2d 383 (Ct. Cl. 1960) (taxpayer need not have "significant investment abroad"); Barber-Greene Americas, Inc., 35 T.C. No. 45 (1960) (title passage was not a sham).

109. The current gold drainage problem would seem tailormade for the exporter concerned about possible invasion of his existing tax advantages.

granting tax concessions to foreign trade and investment; there is concrete evidence that Congress will not be stampeded simply on broad general grounds that particular concessions are necessary in order to encourage foreign investment. The foregoing change in congressional attitude has been manifested by the struggle with tax-sparing in the Pakistan Treaty, and more recently in the 86th Congress with the Boggs Bill. *Inter alia,* the Boggs Bill started with a "14 point" rate reduction and tax-sparing, and passed the House with only a deferral privilege for business income from "less-developed" countries. And the net result is the same whether the foregoing be regarded as a symptom of a Congress more attuned to policy, or a Treasury with more ability to prevent enactment of any concession constituting a substantial drain on the revenue. In short, as potent as argument may be for additional substantial concessions, it is extremely doubtful that they will be brought about in the near future.

What the tax planner can anticipate, however, is further attention by Congress to technical changes designed to flatten out the marked differences in operating in different corporate form overseas, and perhaps restrictions on the use of the foreign situs trust. When form determines such vastly different tax consequences as it does under present law, and when the spotlight has been focused on such technicalities, it can not be expected that Congress will leave this portion of the tax law long unattended. There is, in fact, much evidence that Congress is coming to appreciate more fully one of the basic tenets of taxation; that applied to this area the primary need of overseas trade and investment is that of flexibility in legal form when tax considerations remain as neutral as possible. The Boggs Bill's proposals permitting Foreign Business Corporations to function as base companies,[110] the "grossing-up" proposals in computing the foreign tax credit in foreign subsidiary operations,[111] and the recently enacted alternative overall limitation on the foreign tax credit,[112] all seem to suggest that equalizing technical change is well under way.[113]

Three implications of equalizing technical change for tax planning may be considered. First, it would seem that while the present variety of corporate forms available for overseas trade and investment will not be disturbed and will perhaps be augmented by the Foreign Business Corporation, United States tax considerations will play a less important role in selection of form. Second, related to the first, if the Boggs Bill in its present form becomes law, the tax planner will be faced with some

110. See notes 60 and 61 *supra.*
111. Note 30 *supra.*
112. Note 4 *supra.*
113. For additional suggested technical changes see Lidstone, *Double Taxation of Foreign Income? Or an Adventure in International Double Talk?* 44 VA. L. REV. 921 (1958).

difficult problems of establishing internal controls necessary to ensure compliance in order to obtain the benefits of the legislation. Third, perhaps this is but a hope, the tax planner should be able to plan on the basis of more articulate congressional policies underlying the technical changes made.